

General Information Letter: Illinois tax treatment of IRC Section 338(h)(10) transactions follows the federal treatment.

April 13, 2007

Dear:

This is in response to your letter dated March 5, 2007 in which you request information regarding Illinois replacement tax. The nature of your request and the information you have provided requires that we respond with a General Information Letter (GIL). A GIL is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 86 Ill. Adm. Code 1200.120(b) and (c), which may be accessed from the Department's web site at www.Iltax.com.

In your letter you have stated the following:

Please review the following facts with regards to the proper treatment of deferred gain for IL S corporation replacement tax.

Company A was a subchapter S Corporation. On June 5, 2006 Company A's stock was acquired by Company B (acquiring corporation) with an IRC section 332(h)(10) (sic) election (with the seller and buyer agreement). Company B is regular (sic) C corporation and is a consolidated taxpayer. Company A ceased to be a subchapter S corporation right after being acquired by Company B. Company B will include Company A's activity from June 6, 2006 thru (sic) the end of the year in its federal consolidated tax return and in its IL unitary tax filing. Owners' of Company A (former S corporation) received part of the sales proceeds on or before June 5, 2006. The remaining sales proceeds including cash in an escrow account was received after June 5, 2006.

Company A filed a short year Federal (Form 1120S) and State of Illinois (Form IL-1120-ST) subchapter S corporation tax return for the tax year beginning January 1, 2006 and ending June 5, 2006 using an installment sales method to report the gain from (sic) the sale of business assets. Such reporting resulted in the deferral of some of the gain on the sale of the stock/assets of Company A. Sellers of Company A's stock aren't required to file a second short year federal return corporate tax return (sic), since they have no ownership interest in Company A. The individuals (former owners of S corporation, Company A), will report the deferred gain on their individual federal and state tax returns upon receipt of the remaining sales proceeds.

What is the proper treatment of the state corporate level deferred gain or IL replacement tax purposes? Who is responsible or (sic) the IL S corporation replacement tax on the deferred (unreported) gain, if there is any tax? Does the tax responsibility attributable to the deferred gain falls (sic) on the previous owners of Company A (pre 6/6/06 owners) or the present owners? Does the deferred gain escape taxation, since there will (sic) is no requirement to file a federal and state S corporation tax return to report the deferred gain?

RULING

Section 201(a) of the Illinois Income Tax Act ("IITA" ; 35 ILCS 5/201(a)) imposes an income tax upon

every corporation for the privilege or earning or receiving income in or as a resident of Illinois. Section 201(c) of the IITA imposes the Personal Property Tax Replacement Income Tax (replacement income tax) upon every corporation (including Subchapter S corporations) for the privilege of earning or receiving income in or as a resident of Illinois. Under IITA section 205, an S corporation is exempt from the tax imposed under section 201(a), but is subject to replacement income tax and is required to file returns under Article 5 of the IITA.

Replacement income tax is imposed upon a taxpayer's "net income" as defined in IITA section 202. Net income under section 202 is that portion of a taxpayer's "base income" allocable to Illinois under Article 3, less a standard exemption and net operating loss deduction. In the case of a corporation, "base income" is defined under IITA section 203(b) to mean the taxpayer's taxable income as modified by the addition and subtraction items set forth in that section. Under IITA section 203(e)(2)(G), the taxable income of an S corporation is generally the taxable income of such corporation determined for federal income tax purposes in accordance with section 1363(b) of the Internal Revenue Code (Code), including the items required to be separately stated under Code section 1363(b)(1). Under IITA section 402(a), the method of accounting used by a taxpayer for federal income tax purposes apply in computing its Illinois income tax liability. Since the base income of an S corporation starts with the corporation's taxable income as determined for federal income tax purposes, the federal rules related to the computation of an S corporation's income, including the deemed asset sale provisions of Code sections 338(h)(10) and the installment obligation distribution provisions of Code section 453B(h), apply for purposes of determining an S corporation's Illinois replacement income tax liability.

Treasury Regulations section 1.338(h)(10)-1(c) allows a section 338(h)(10) election to be made in the context of a qualified stock purchase of S corporation stock. The regulations set forth the tax consequences of the election to the S corporation target and the S corporation shareholders. As to the S corporation target, Treasury Regulations section 1.338(h)(10)-1(d)(3)(i) provides that the target is treated as transferring all of its assets to an unrelated person in a single transaction at the close of the acquisition date (but before the deemed liquidation). The regulations further specify that the target realizes the deemed sale tax consequences from the deemed asset sale before the close of the acquisition date and while the target is owned by the S corporation shareholders, and that the target's S election continues in effect through the close of the acquisition date (including the time of the deemed asset sale and the deemed liquidation). Under Treasury Regulations section 1.338(h)(10)-1(d)(4)(i), the target is treated as if, before the close of the acquisition date, after the deemed asset sale, and while the target is owned by the S corporation shareholders, it transferred all of its assets to the S corporation shareholders and ceased to exist. Treasury Regulations section 1.338(h)(10)-1(d)(5) provides that the shareholders of the S corporation target must take into account their pro rata share of the deemed sale tax consequences under Code section 1366, and then are treated as if, after the deemed asset sale and before the close of the acquisition date, they received the assets of the target transferred to them in the deemed transfer described in 1.338(h)(10)-1(d)(4)(i). In the case where a qualified stock purchase is made on an installment sale basis, Treasury Regulations section 1.338(h)(10)-1(d)(8)(i) provides that the target is treated as receiving in the deemed asset sale installment obligations, the terms of which are identical (except that the obligor is the deemed new corporation) to the installment obligations actually received by the S corporation shareholders for the recently purchased stock of target. Section 1.338(h)(10)-1(d)(8)(ii) then states that the target is treated as distributing in the deemed liquidation the installment obligations that it is treated as receiving in the deemed asset sale to the S corporation shareholders who actually received installment obligations.

As indicated above, the provisions of Code section 338(h)(10) apply in determining the base income of an S corporation for Illinois replacement income tax purposes. As under the federal rules, an S corporation is treated for Illinois replacement income tax purposes as if it actually engaged in the transactions deemed to occur as a result of the federal election. Accordingly, the S corporation's Illinois base income includes gain or loss recognized on the deemed asset sale. To the extent that gain from the deemed asset sale is taken into account under the installment method, and therefore recognized as payments are received on the obligation, the gain is likewise so recognized for Illinois replacement tax purposes. Similarly, an S corporation's Illinois base income includes gain or loss recognized on the deemed liquidation or transfer under Treasury Regulations section 1.338(h)(10)-1(d)(4)(i). To the extent that gain on such transfer is not recognized for federal income tax purposes, including under Code section 453B(h), the gain is likewise not recognized for Illinois replacement tax purposes.

As stated above, this is a GIL. A GIL is does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you have further questions regarding this GIL, please call (217) 782-7055. If you have additional questions regarding Illinois income tax laws, please visit the Department's web site at www.Iltax.com.

Sincerely,

Brian L. Stocker
Associate Counsel (Income Tax)